No. 16024

IN THE

United States Court of Appeals

FOR THE NINTH CIRCUIT

ADVANCE TRUCK COMPANY, a corporation,

Petitioner,

vs.

COMMISSIONER OF INTERNAL REVENUE,

Respondent.

BRIEF FOR THE PETITIONER WITH APPENDICES.

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Advance Truck Company, a corporation,

Petitioner,

vs.

Commissioner of Internal Revenue,

Respondent.

BRIEF FOR THE PETITIONER WITH APPENDICES.

Opinion Below.

The findings of fact and opinion of the Tax Court [R. 39-47] are reported at 29 T. C. 666.

Jurisdiction.

This petition for review [R. 48-51] involves federal income and excess profits taxes for the taxable year 1950. On May 11, 1955, the Commissioner of Internal Revenue mailed to Petitioner a notice of deficiency in the total amount of $3,618.14 [R. 9-16]. Within 90 days thereafter and on August 3, 1955, the Petitioner filed a petition for redetermination of that deficiency under the provisions of Section 6213 of the Internal Revenue Code of 1954 [R. 3-16]. The decision of the Tax Court was entered on January 29, 1958 [R. 47]. The case was brought to this Court by a petition for review filed on

April 14, 1958 [R. 48-51]. Jurisdiction is conferred on this Court by Sections 7482 and 7483, 1954 Internal Revenue Code.

Question Presented.

The Petitioner, prior to the year 1950, kept its books of account and reported its income for federal income tax purposes on the cash receipts and disbursements method. Pursuant to a directive of the Interstate Commerce Commission, the Petitioner, on January 1, 1950, changed its method of keeping its books of account to an accrual method.

The Question presented is whether the Petitioner's income for federal income tax purposes for the year 1950 is to be computed according to the strict accrual method as contended by the Petitioner, or whether, as the Tax Court held, the income is to be computed by a hybrid method, which is a partly cash receipts and disbursements method and a partly accrual method.

Statutes and Regulations Involved.

The relevant portions of the statutes and regulations involved are set forth in Appendix A, *infra.*

Statement.

The stipulated facts [R. 20-27] may be summarized as follows:

The Petitioner is a common carrier and is engaged in the business of hauling and storing tubular goods for hire. It does not engage in manufacturing, processing, purchasing or selling merchandise. Its business does not require the use of inventories and inventories are not an income-producing factor. From the date of its incorporation through December 31, 1949, it properly kept its books of account and properly reported its income for

federal income tax purposes on the cash receipts and disbursements method [R. 20-21].

As of January 1, 1950 the Petitioner, pursuant to a directive of the Interstate Commerce Commission [R. 21, 27-29], changed its method of keeping its books of account to an accrual method [R. 23].

In reporting its income for the calendar year 1950 the Petitioner included in the gross receipts in its income tax return the accounts receivable at December 31, 1950. Petitioner also included in the gross receipts shown on the return an amount received during January 1950 for services rendered during the month of December 1949, which on the accrual method of accounting would have represented accounts receivable at December 31, 1949 [R. 23].

On or about January 14, 1954, the Petitioner filed a timely claim for refund with the Respondent claiming an overpayment of taxes for the taxable year 1950 on the grounds that it was properly on the cash basis for the purposes of reporting its income for federal income and excess profits taxes [R. 25, 37]. On May 11, 1955, the Respondent issued a notice of deficiency [R. 9-16] by which he rejected the Petitioner's claim for refund and determined that the Petitioner was required to report its income on the accrual method [R. 11]. The respondent made certain adjustments to Petitioner's income which were not contested in the Tax Court. The Petitioner claimed in its petition to the Tax Court that if the Respondent's determination that the Petitioner was required to report its income on the accrual method was correct, its income for the calendar year 1950 should be computed by eliminating from gross receipts the accounts receivable at December 31, 1949, which on the accrual method of

accounting were not income to the Petitioner in the year 1950 [R. 4, 7-8]. Such a recomputation would result in an overpayment by the Petitioner of its income and excess profits tax for the calendar year 1950.

The Tax Court in its opinion held that the Petitioner was required to report its net income for federal income tax purposes on the accrual method for the calendar year 1950, and that under the provisions of Section, 42, 1939 Internal Revenue Code, the accounts receivable at December 31, 1949 were income of the Petitioner in the year 1950 when received [R. 43, 45-46].

On the basis of its opinion, the Tax Court entered its decision that there was no overpayment in income and excess profits taxes due to the Petitioner for the year 1950 [R. 47].

Specifications of Error.

The Tax Court of the United States erred:

1. In holding that under the provisions of Section 42, 1939 Internal Revenue Code, the accounts receivable at December 31, 1949 were income of the Petitioner in the taxable year 1950 when received, when Petitioner was required to change to an accrual method of reporting its income for the taxable year 1950.

2. In failing to hold that the Petitioner was entitled to have its income for the taxable year 1950 recomputed by the elimination of amounts which were not income to the Petitioner for the taxable year 1950 according to the accrual method of accounting.

3. In failing to hold and decide that there is an overpayment in income and excess profits tax due to the Petitioner for the taxable year 1950 in an amount to be determined under Rule 50 of the Rules of Practice of the Tax Court.

Summary of Argument.

The Tax Court's interpretation of Section 42, 1939 Internal Revenue Code, is contrary to and in conflict with Section 41, 1939 Internal Revenue Code. The interpretation of Section 42 by that Court is opposed to the decided cases and is based on the identical reasoning of *Hardy v. Commissioner* (C. A. 2, 1936), 82 F. 2d 249, which has been overruled.

Argument.

Section 41, Internal Revenue Code of 1939, provides that a taxpayer's net income shall be computed upon the basis of the taxpayer's annual accounting period in accordance with the method of accounting employed in keeping the books of the taxpayer, unless the method employed does not clearly reflect net income, in which case it shall be computed in accordance with such method as in the opinion of the Commissioner does clearly reflect net income. The Tax Court found that during the year 1950 the Petitioner, Advance Truck Company, maintained its books of account on an accrual method of accounting [R. 41]. It further found that on the accrual method of accounting the amounts received during January 1950 for services rendered during December 1949 would have represented accounts receivable at December 31, 1949 [R. 42]. The annual accounting period of the Petitioner was a calendar year [R. 20]. On the accrual method of accounting an item is included in income when earned and not when received. (*Graham Mill & Elevator Co. v. Thomas* (C. A. 5, 1945), 152 F. 2d 564, 565.) On the accrual method of accounting, the accounts receivable at December 31, 1949 were not income in the year 1950, and on an annual basis of taxation may not

be included in income for 1950. (*Robert G. Frame* (1951), 16 T. C. 600, aff'd (C. A. 3, 1952), 195 F. 2d 166.)

> "All the revenue acts which have been enacted since the adoption of the Sixteenth Amendment have uniformly assessed the tax on the basis of annual returns showing the net result of all the taxpayer's transactions during a fixed accounting period . . ."
>
> *Burnet v. Sanford & Brooks Co.,* 282 U. S. 359, 363, 51 S. Ct. 150, 75 L. Ed. 383;
>
> *Security Flour Mills Co. v. Commissioner,* 321 U. S. 281, 64 S. Ct. 596, 88 L. Ed. 725.

The method of accounting employed by a taxpayer in keeping his books of account controls as to the time as of which items of gross income are to be accounted for, unless the *method* employed does not clearly reflect his income. (Regulation 111, Sec. 29.41-1.) Method of accounting means the way of keeping the taxpayer's books according to a definite and regular plan. (*Huntington Securities Corp. v. Busey* (C. A. 6, 1940), 112 F. 2d 368, 370.) The Respondent has determined [R. 11] and the Court has found that during the taxable year 1950 the accrual method was the proper basis for keeping the Petitioner's books and reporting its income. The Commissioner has not contended nor did the Court find that the accrual method did not clearly reflect the Petitioner's income for the year 1950.

The Tax Court's interpretation of Section 42, Internal Revenue Code of 1939, as requiring the inclusion in gross income of the amounts received in 1950 for services rendered in 1949 is in conflict with and contrary to the provision of Section 41, Internal Revenue Code of 1939. Section 42 provides that all items of gross income shall

be included in the gross income of the taxpayer for the taxable year in which received unless under methods of accounting permitted under Section 41 they are to be accounted for as of a different period. The Tax Court's interpretation of Section 42, as applied to the facts of this case, is illustrated by the following language from its opinion [R. 46-47]:

> "The answer to this argument is that under section 42, supra, every taxpayer is required to report every item of gross income that he receives in some year. It is either the year of receipt or some other year when it could be properly accounted for. When, as here, there is no other year when it could be properly accounted for, then the fact that the year of receipt is an accrual year for reporting, is immaterial. The statute does not say the item shall be included in income in the year of receipt, if that would be proper according to the method of accounting then being employed by the taxpayer. The method of accounting of the taxpayer in the year of receipt, and whether that method was the result of a voluntary or involuntary change-over, are both immaterial."

Under Section 41, net income is computed in accordance with the method employed in keeping the books of the taxpayer. "Net income" is defined in Section 21, Internal Revenue Code of 1939, as the "gross income" less "deductions." Under the Tax Court opinion the Petitioner's gross income is to be computed upon a basis which is neither cash nor accrual. Under the provisions of Section 41, however, its net income, which is gross income less deductions, is to be computed according to its books of account which for the taxable year 1950 were maintained on an accrual method. The Tax Court's interpretation of Section 42 renders meaningless the pro-

visions of Section 41 since it would be an impossibility to compute gross income for a taxable period in one way under Section 41 and another way under Section 42. It is significant that the Court cited no authority for its holding, which is contrary to the Respondent's regulations and the decided cases. Regulation 111, Section 29.41-1, states in part:

> "Sec. 29.41-1. *Computation of net income.* Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. * * * If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. * * *"

The courts have held, in interpreting Sections 41, 42 and 43, 1939 Internal Revenue Code, that neither income nor deductions may be taken out of the proper accounting period for the benefit of the Respondent or the taxpayer.

> "But we think it was not intended to upset the well understood and consistently applied doctrine that cash receipts or matured accounts on one hand, and cash payments or accrued definite obligations on the other, should not be taken out of the annual accounting system and, for the benefit of the Government or the taxpayer, treated on a basis which is neither a cash nor an accrual basis, because so to do would, in a given instance, work a supposedly more equitable result to the Government or to the taxpayer."

Security Flour Mills Company v. Commissioner, supra.

The controversy herein involved arose by reason of the change of accounting method between two taxable years. Neither the Internal Revenue Code of 1939, nor its predecessors, prescribed the tax consequences of a transition from the cash to the accrual method. The attempt by the Tax Court to attribute to Section 42 that prescription as applied to the facts of this case is contrary to the decided cases. The reasoning of the Tax Court in this proceeding is precisely the same as in *William Hardy, Inc. v. Commissioner* (C. A. 2, 1936), 82 F. 2d 249, which was specifically overruled by *Commissioner v. C. J. Dwyer* (C. A. 2, 1953), 203 F. 2d 522. In *Hardy,* the taxpayer changed its method of keeping its books of account from a cash to an accrual method. The Respondent, in the year of changeover, required the income to be computed and reported on the accrual basis and additionally included in the income for the year of changeover the accounts receivable at December 31 of the prior year. The Court stated:

> "The accounts receivable at December 31, 1924 were correctly included also. They were not taxable on the cash basis and if strict accrual principles are to prevail beginning with January 1, 1925 they never would be taxable since they represent previous transactions which could not be accrued in 1925 or thereafter nor would payments made upon them after the beginning of 1925 figure in the computation of income since the cash basis no longer was to be used. Yet to the extent that they were thereafter paid they were in fact the income of the petitioner. There is no provision in the law which permits them escape from taxation if received. *On the contrary Sec. 213(a) of the 1926 Act required that all income received by a taxpayer in any taxable year should be reported in that year unless under permitted methods*

> *of accounting it was properly to be accounted for as of a different period. These accounts receivable were therefore correctly added to the net income reported by the petitioner for 1925 as though they had actually accrued in that period.*" (Emphasis supplied.)

The portion of Section 213(a) of the 1926 Revenue Act referred to by the Court is identical to Section 42 of the Internal Revenue Code of 1939. Since the Tax Court's reasoning has been disavowed by the overruling of the *Hardy* case, it follows that there is no authority for its holding in this proceeding.

The Tax Court and various Circuit Courts have since *Hardy* considered the tax effects of a change in the manner of reporting income. (*Goodrich v. Commissioner* (C. A. 8, 1957), 243 F. 2d 686; *Dwyer, supra; Caldwell v. Commissioner* (C. A. 2, 1953), 202 F. 2d 112; *Welp v. United States* (C. A. 8, 1953), 201 F. 2d 128; *Commissioner v. Cohn* (C. A. 2, 1952), 196 F. 2d 1019; *Commissioner v. Schuyler* (C. A. 2, 1952), 196 F. 2d 85; *Commissioner v. Frame* (C. A. 3, 1952), 195 F. 2d 166; *Commissioner v. Mnookin's Estate* (C. A. 8, 1950), 184 F. 2d 89; *David W. Hughes* (1954), 22 T. C. 1; *Clement A. Bauman* (1954), 22 T. C. 7; *E. S. Iley* (1952), 19 T. C. 631, overruled by *Hughes, supra*.) In some of these cases, *e.g., Mnookin's Estate,* the taxpayer's books were kept on an accrual basis, but part of the income was reported on a cash basis. In other cases, *e.g., Welp, Goodrich, Iley,* the books were kept and income reported on a cash basis. The Commissioner in each of the above cited cases determined that the taxpayer was required to report the income on an accrual basis and attempted in the year of changeover to require the taxpayer to include in income accounts receivable of

prior years, or denied the taxpayer the right to use opening inventories. The courts in the above cases have unanimously held that on the changeover from a cash to an accrual method of reporting income the strict accrual method must be used in computing income for the taxable year of the changeover. All of the foregoing cases have distinguished or disavowed the *Hardy* rationale and have held that the Commissioner does not have the right, under Section 41 of the Internal Revenue Code of 1939, to prescribe a hybrid method of reporting income as the Tax Court has held in this case. The Tax Court in its opinion [R. 44] distinguished the cited cases on the basis that these were cases in which the taxpayers did not keep their books or report income on an entirely proper basis and that the Commissioner was attempting to tax amounts that had not been received or that should have been accrued as income in a prior year not before the court. This distinction, if valid, would explain the cases in which the taxpayers kept books on an accrual basis, but reported income on a cash basis, but it does not explain such cases as those in which the taxpayer kept its books and reported its income on a cash basis. In such cases as *Welp, supra, Goodrich, supra,* and *Iley, supra,* the taxpayer was following the requirements of Section 41 and reporting income on the basis of its accounting method. Accounts receivable could not be properly accrued in years prior to the changeover under Section 42 because the accounting method used in the prior years was a cash method as in the case of the Petitioner here. The distinction is without merit if the provisions of Section 41 are to be followed. It is submitted that all of the cited cases have been decided on a consistent interpretation of Section 41.

The Tax Court in *Robert G. Frame, supra,* stated that Section 41, 1939 Internal Revenue Code, did not give the Commissioner the authority to add to a taxpayer's gross income for a given year an item which rightfully belongs in an earlier year under the accrual method of accounting, citing *Clifton Mfg. Co. v. Commisisoner* (C. A. 4, 1943), 137 F. 2d 290, and *Security Flour Mills Co. v. Commissioner, supra.* Similarly, the Court of Appeals for the Eighth Circuit held in *Commissioner v. Mnookin's Estate, supra,* that the Commissioner had no authority under Section 41 to disregard the taxpayer's accounting methods in determining the time as of which an item is reported. It is submitted that if Section 41 does not so empower the Commissioner, then Section 42 cannot be construed so to do. An additional indication of the lack of authority under the provision of the Internal Revenue Code of 1939 is the fact that Congress found it necessary to enact Section 481 of the 1954 Internal Revenue Code to provide authority for making adjustments upon a change of the method of accounting. (Sen. Rept. No. 1622, 83rd Cong., 2nd Sess., p. 307.)

Conclusion.

For the reasons stated above, the decision of the Tax Court should be reversed.

Respectfully submitted,

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August ......, 1958.

APPENDIX A.

STATUTES.

1939 Internal Revenue Code.

Sec. 21. Net Income.

(a) Definition.—"Net income" means the gross income computed under section 22, less the deductions allowed by section 23.

Sec. 41. General Rule.

The net income shall be computed upon the basis of the taxpayer's annual accounting period (fiscal year or calendar year, as the case may be) in accordance with the method of accounting regularly employed in keeping the books of such taxpayer; but if no such method of accounting has been so employed, or if the method employed does not clearly reflect the income, the computation shall be made in accordance with such method as in the opinion of the Commissioner does clearly reflect the income. If the taxpayer's annual accounting period is other than a fiscal year as defined in Section 48 or if the taxpayer has no annual accounting period or does not keep books, the net income shall be computed on the basis of the calendar year.

Sec. 42. Period in Which Items of Gross Income Included.

(a) General Rule.—The amount of all items of gross income shall be included in the gross income for the taxable year in which received by the taxpayer, unless, under methods of accounting permitted under section 41, any such amounts are to be properly accounted for as of a different period. . . .

SEC. 43. PERIOD FOR WHICH DEDUCTIONS AND CREDITS TAKEN.

The deductions and credits (other than the corporation dividends paid credit provided in section 27) provided for in this chapter shall be taken for the taxable year in which "paid or accrued" or "paid or incurred", dependent upon the method of accounting upon the basis of which the net income is computed, unless in order to clearly reflect the income the deductions or credits should be taken as of a different period. . . .

Revenue Act of 1926 (44 Stat. 23).

GROSS INCOME DEFINED.

SEC. 213. For the purposes of this title, except as otherwise provided in section 233—

(a) The term "gross income" includes gains, profits, and income derived from salaries, wages, or compensation for personal service (including in the case of the President of the United States, the judges of the Supreme and inferior courts of the United States, and all other officers and employees, whether elected or appointed, of the United States, Alaska, Hawaii, or any political subdivision thereof, or the District of Columbia, the compensation received as such), of whatever kind and in whatever form paid, or from professions, vocations, trades, businesses, commerce, or sales, or dealings in property, whether real or personal, growing out of the ownership or use of or interest in such property; also from interest, rent, dividends, securities, or the transaction of any business carried on for gain or profit, or gains or profits and income derived from any source whatever. The amount of all such items shall be included in the gross income for the taxable year in which received by

the taxpayer, unless, under methods of accounting permitted under subdivision (b) of section 212, any such amounts are to be properly accounted for as of a different period.

United States Treasury Department Regulations.

Regulations 111.

Sec. 29.41-1. *Computation of net income.*

. . . Net income must be computed with respect to a fixed period. Usually that period is 12 months and is known as the taxable year. Items of income and of expenditure which as gross income and deductions are elements in the computation of net income need not be in the form of cash. It is sufficient that such items, if otherwise properly included in the computation, can be valued in terms of money. The time as of which any item of gross income or any deduction is to be accounted for must be determined in the light of the fundamental rule that the computation shall be made in such a manner as clearly reflects the taxpayer's income. If the method of accounting regularly employed by him in keeping his books clearly reflects his income, it is to be followed with respect to the time as of which items of gross income and deductions are to be accounted for. (See sections 29.42-1 to 29.42-3, inclusive.) If the taxpayer does not regularly employ a method of accounting which clearly reflects his income, the computation shall be made in such manner as in the opinion of the Commissioner clearly reflects it.

Sec. 29.42-1. *When included in gross income.*

(a) In general.—Except as otherwise provided in section 42, gains, profits, and income are to be included in the gross income for the taxable year in which they are received by the taxpayer, unless they are included as of a different period in accordance with the approved method of accounting followed by him. . . .

APPENDIX B.

Table of Exhibits Pursuant to Rule 2(f) as Amended.

Exhibits	Identified, Offered and Received
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